

INTERNATIONAL PRACTICE UNIT: LICENSE OF INTANGIBLE PROPERTY FROM U.S. PARENT TO A FOREIGN SUBSIDIARY

Author
Christine Long

Tags
Arm's Length
Code §482
C.F.C.
Foreign Subsidiary
Intangible Property
International Practice Units
LB&I
License
Transfer Pricing
Treas. Reg. §1.482-4

INTRODUCTION

The I.R.S.'s Large Business and International ("LB&I") Division issued a new International Practice Unit on November 4, 2015 called "License of Intangible Property from U.S. Parent to a Foreign Subsidiary" (the "Practice Unit").¹ As the name suggests, this Practice Unit focuses on the transfer of intangible property ("I.P.") exclusively by means of a license from a U.S. parent ("U.S.P.") to a related foreign entity, which may be the U.S.P.'s wholly-owned controlled foreign corporation ("C.F.C.").

The transfer pricing rules dictate that a license of I.P. from a U.S. person to a related foreign subsidiary must be at arm's length, as determined by Internal Revenue Code §482² and Treas. Reg. §1.482-4. The I.R.S. has decided to focus on this issue because if a foreign related entity pays its U.S.P. compensation for the use of I.P. that is less than an arm's length consideration, the U.S.P. will report income that is below the level of true taxable income.³ Under Code §482, the I.R.S. can reallocate the income by increasing the U.S.P.'s income and decreasing the foreign entity's income. The Practice Unit is designed to target the C.F.C.'s use of the licensed I.P. and consider whether the C.F.C. paid the U.S.P. an arm's length amount to use the property.⁴

TRANSACTION AND FACT PATTERN

The Practice Unit provides an example of the I.P. license transaction involving a U.S.P. and its C.F.C. in order to present the issues and to provide a step-by-step audit approach to the examination of the license transaction.

The fact pattern established in the Practice Unit is that of a U.S.P. that was formerly only a U.S. business but has globally expanded to become a parent company of a worldwide group, which designs, develops, manufactures, sells, and distributes products worldwide. The U.S.P. conducts all research and development, owns all intellectual property, and sells and distributes products into the U.S. market. In order to expand, the U.S.P. licenses its I.P. to a C.F.C. in order for the C.F.C. to use the property to sell and distribute products into all non-U.S. markets.⁵ The C.F.C. is

¹ "License of Intangible Property from U.S. Parent to a Foreign Subsidiary," LB&I, November 4, 2015.

² All section references are to the Internal Revenue Code of 1986, as amended, (the "Code") and the regulations promulgated thereunder.

³ "License of Intangible Property from U.S. Parent to a Foreign Subsidiary," p. 3.

⁴ *Id.*

⁵ *Id.*, p. 5.

in a country with a low corporate tax rate. The overall effective tax rate in this fact pattern will be reduced improperly since income will be shifted to the low-tax foreign corporation from the U.S.⁶

It is important to note that if the C.F.C. is in a country in which a withholding tax provision of a tax treaty applies, the royalty payments received by the U.S.P. must utilize the treaty withholding rate reduction since any overpayment of withholding tax would not be categorized by the I.R.S. as a mandatory tax payment. Instead, it is viewed as a “voluntary payment” rather than a tax and would not be eligible to be claimed as a foreign tax credit.

ISSUES & AUDIT PROCEDURES

The Practice Unit has identified three potential issues that examiners should focus on when a U.S.P. licenses I.P. to a C.F.C.:

1. What I.P. rights have been licensed from the U.S.P. by the C.F.C.?
2. Did the U.S.P. receive arm’s length consideration for the license of I.P. to the C.F.C.?
3. Was the consideration commensurate with income (“C.W.I.”) attributable to the I.P.?⁷

The Practice Unit provides a step-by-step approach for how to conduct an audit of each issue. The first step, which applies to all three issues, is to ensure that a license of I.P. occurred by establishing the facts and supporting documentation to substantiate the license.

The Practice Unit focuses on five elements in order to establish the facts of the transaction:

1. Did the U.S.P. transfer I.P. under a licensing agreement to its C.F.C.?
2. What type of I.P. did the U.S.P. license to its C.F.C.?
3. Are the I.P. routine in nature or non-routine type I.P.?
4. What form of consideration (e.g., lump sum, contingent payment, or installment payment) was received by the U.S.P.?
5. Does the Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, represent that rents, royalties, and license fees were paid by the C.F.C.?⁸

In order to examine these elements, the Practice Unit suggests referring to the following resources for guidance: transfer pricing studies, organizational charts, license agreements, intercompany agreements, invoices, taxpayer’s financial statements, transfer pricing roadmaps, the taxpayer’s internet site, and/or a mandatory

⁶ *Id.*, p. 6.

⁷ *Id.*, p. 7.

⁸ *Id.*, p. 8.



transfer pricing I.D.R. To establish the facts under the element regarding Form 5471, the Practice Unit suggests referring to schedule M, line 20.⁹

Once the facts for each case are developed, the analysis of each issue begins. The Practice Unit instructs the examiner to review potential sub-issues, perform additional factual development, and finally develop arguments for each issue concerned with the I.P. licensing.

Rights Licensed to the C.F.C.

In order to address the issue of what I.P. rights have been licensed from the U.S.P. to the C.F.C., the Practice Unit defines the terms at issue and explains the subject of the examination as outlined below:

- For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual:
 - Patents, inventions, formulae, processes, designs, patterns, or know-how;
 - Copyrights and literary, musical, or artistic compositions;
 - Trademarks, trade names, or brand names;
 - Franchises, licenses, or contracts;
 - Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
 - Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.
- A controlled transfer of Intangible Property means any transaction or transfer of such property between two or more members of the same group of controlled taxpayers. Determine if in fact an intangible as defined in Treas. Reg. 1.482-4(b) has been transferred from the USP to the CFC under a licensing arrangement.
- Determine what rights to the intangibles were transferred? Here are examples of the type of rights that may be transferred under a licensing arrangement.
 - Exclusive v. Non Exclusive
 - Sublicensing Rights
 - Geographic Rights

⁹ *Id.*

- Manufacturing, Marketing, Distribution (Make/Sell)
- Research Rights.¹⁰

The Practice Unit instructs the examiner to refer to Treas. Reg. §1.482-1(i)(7), Treas. Reg. §1.482-1(i)(8), and Treas. Reg. §§1.482-4(a) and (b).

Next, the Practice Unit instructs the examiner to answer the following questions by referring to the U.S.P.'s and C.F.C.'s transfer pricing roadmaps and studies, license agreements, intercompany agreements, and/or their internet sites:

- Is there a license of I.P. between controlled parties?
- What type of I.P. is being licensed?
- What rights to the I.P. were licensed?¹¹

The examiner must consider all the facts and circumstances of each specific case in order to determine whether the U.S.P.'s I.P. has been licensed. The examiner must establish that there is a controlled transfer of I.P. under a licensing arrangement pursuant to Treas. Reg. §§1.482-1(i)(7) and (i)(8), and §§1.482-4(a) and (b). In the analysis, the examiner must determine the type of I.P., the rights associated with that I.P., and whether the U.S.P. was properly compensated for the transfer of such I.P. under the licensing arrangement.¹² If the examiner determines that there was a license of I.P. rights that required the C.F.C. to make an arm's length payment to the U.S.P., the examiner may proceed to the next issue.¹³

Arm's Length Consideration for the License

In order to address the issue of whether the U.S.P. received arm's length consideration for the I.P. license to the C.F.C., the Practice Unit establishes that in a controlled transfer of I.P., arm's length consideration must be determined under one of four methods listed in Treas. Reg. §1.482-4(a), *i.e.*, the Comparable Uncontrolled Transaction ("C.U.T.") method,¹⁴ Comparable Profits Method ("C.P.M."),¹⁵ Profit Split method,¹⁶ or the Unspecified Method.¹⁷ Each method must be applied according to the provisions of Treas. Reg. §1.482-1, including the Best Method Rule of Treas. Reg. §1.482-1(c), the comparability analysis of Treas. Reg. §1.482-1(d), and the arm's length range of Treas. Reg. §1.482-1(e). The Practice Unit further explains the issue as follows:

- If the Taxpayer applies one of the methods in Treas. Reg. 1.482-4(a), and that method achieves the most reliable measure of an arm's length result, it will be considered the best method.

¹⁰ *Id.*, p. 9-10.

¹¹ *Id.*, p. 11.

¹² *Id.*, p. 12.

¹³ *Id.*, p. 13.

¹⁴ Treas. Reg. §1.482-4(c).

¹⁵ Treas. Reg. §1.482-5.

¹⁶ Treas. Reg. §1.482-6.

¹⁷ Treas. Reg. §1.482-4(d).

“In a controlled transfer of I.P., arm's length consideration must be determined under one of four methods listed in Treas. Reg. §1.482-4(a).”

- If the CUT Method is selected as the best method, additional comparability analysis under Treas. Reg. 1.482-4(c)(2) needs to be considered, as well.
- If the consideration received by the USP falls within the arm's length range under the best method, no adjustment is necessary.¹⁸

The Practice Unit instructs the examiner to consider the amount paid by the C.F.C. to the U.S.P., as well as the following questions, in light of the company's various agreements, ledgers, financial statements, and other documents that could be useful in determining whether there was arm's length consideration:

- What was the form of the consideration?
 - Lump sum
 - Installment
 - Contingent payment e.g. Royalty
- What method did USP select in determining the arms length compensation to receive from CFC?
 - Comparable Uncontrolled Transaction
 - Comparable Profits Method
 - Profit Split
 - Unspecified Method
- What are the functions, risks, and assets employed respectively by the USP and CFC?
- Was the method selected the best method based on facts and circumstances?
 - Comparability
 - Completeness and Accuracy of Data
 - Reliability of Assumptions
 - Sensitivity of Results
- What was the arm's length range under the best method selected?
 - Comparables
 - Multiple Year Data
 - Interquartile Range¹⁹



¹⁸ “License of Intangible Property from U.S. Parent to a Foreign Subsidiary,” p. 14.

¹⁹ *Id.*, p. 15-17.

“The arm’s length consideration for the transfer of an intangible from USP to CFC must be commensurate with the income attributable to the intangible.”

After establishing that there is a controlled transfer of I.P. by the U.S.P. to the C.F.C. under a licensing arrangement, the examiner must determine whether the U.S.P. received an arm’s length consideration from the C.F.C. The arm’s length consideration must be determined under one of the methods enumerated in Treas. Reg. §1.482-4(a): C.U.T., C.P.M., Profit Split, or Unspecified Method.²⁰ The examiner must consider all the facts and circumstances of each specific case in order to determine whether the best method was chosen. Furthermore, the examiner must ensure the U.S.P.’s comparables are truly comparable to its line of business and its controlled transfer. If the consideration received by the U.S.P. is not within the arm’s length range, the examiner is instructed to adjust the income.²¹

Consideration that is Commensurate with Income (“C.W.I.”) from I.P.

In order to address the issue of whether the consideration paid by the C.F.C. was C.W.I. attributable to the I.P. licensed by the U.S.P., the Practice Unit defines the terms for purposes of an examination and explains the subject as follows:

- The arm’s length consideration for the transfer of an intangible from USP to CFC must be commensurate with the income attributable to the intangible. There are exceptions to applying CWI to the compensation charged by USP if the requirements under Treas. Reg. 1.482-4(f)(2)(ii)(A),(B),(C),(D) and (E) are met.
- Typically, if USP retained a substantial interest in the licensed intangible property, the arms length consideration subject to CWI shall be in the form of a periodic (usually annual) royalty, calculated at the time of the license using forecasted profits or cost savings attributed to the licensed intangible.
- Generally, if the licensing arrangement between USP and CFC covers more than one year, it may be possible to make an adjustment to the compensation charged in each taxable year under the method chosen to ensure that it is commensurate with the income being generated from the use of the intangible by CFC.
- Such adjustment may be possible if all of the requirements for applying CWI are met and the taxpayer does not qualify for one of the exceptions.
- The questions that need to be answered by the examiner when considering CWI:
 1. Are the profits being earned by the CFC materially disproportionate (in the manner described in the section 482 regulations) to the projected profits that both parties anticipated at the time of original transfer or intangibles?
 2. Does the taxpayer meet any of the exceptions to the application of CWI?

²⁰ *Id.*, p. 18.

²¹ *Id.*, p. 19.

If the answer to question 1 is yes and the answer to the question 2 is no, then it may be possible to make a CWI adjustment.²²

The Practice Unit instructs the examiner to answer the following questions by referring to the transfer pricing roadmaps and studies, contracts, intercompany agreements, and annual reports of the U.S.P. and C.F.C.:

- Does the license arrangement cover more than one year?
- Was nominal or no consideration charged by USP to CFC for the licensed intangible at the inception of the license?
- Did USP retain a substantial interest in the licensed intangible?
- Does the license agreement require CFC to make periodic payments to USP for use of the intangible?
- Do any of the exceptions to CWI apply?
 - CUT with same intangible
 - CUT with Comparable Intangible or Other Method
- Written contract, defined terms and time period, no substantial changes in functions performed, and actual profits or cost savings fall within 80% to 120% of forecasts.
 - Extraordinary events that could not reasonably have been anticipated
 - No CWI adjustments made after 5 years beginning with the first year in which substantial periodic consideration was required to be paid under the license agreement²³

If all of the requirements for applying the C.W.I. principle have been satisfied and the U.S.P. does not meet an exception, the consideration charged by the U.S.P. to the C.F.C. in each taxable year might be adjusted to ensure it is commensurate with the income attributable to such I.P. under Treas. Reg. §1.482-4(f)(2).²⁴

CONCLUSION

The three issues discussed above outline the focus of an I.R.S. examination of whether a C.F.C. paid an arm's length amount to use I.P. developed and owned by its U.S.P. As U.S.-based groups expand abroad and license I.P. to foreign related entities, I.R.S. examinations should be anticipated. The Practice Unit describes how such examinations will be conducted with regard to the arm's length nature of license fees that were, or should have been, paid.

²² *Id.*, p. 20-21.

²³ *Id.*, p. 22-23.

²⁴ *Id.*, p. 24.